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Message Text

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C O N F I D E N T I A L SECTION 1 OF 3 JAKARTA 0969

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TAGS: PFOR, ECON, ID, XE, XP
SUBJECT: EAST ASIA ECONOMIC POLICY REVIEW

REF: (A) JAKARTA 0782, (B) 77 STATE 299030

1. FOLLOWING IS SECOND INSTALLMENT OF OUR CONTRIBUTION TO SUBJECT REVIEW AND DEALS WITH (A) ECONOMIC IMPACT OF 1977 POLITICAL DEVELOPMENTS AND (B) 1977 ECONOMIC HIGHLIGHTS AND THEIR POLICY IMPLICATIONS.
A. 1977 POLITICAL DEVELOPMENTS

2. MAY ELECTIONS: THE MAY 1977 ELECTIONS WHICH TENDED TO CONFIRM THE EXISTING POLITICAL ORDER HAD NO SUBSTANTIAL IMPACT ON THE DOMESTIC ECONOMY OR ON INDONESIA'S POLICIES IN INTER-NATIONAL ECONOMIC ISSUES. THE UNCERTAINTIES OF THE PRE-ELECTION PERIOD, COMBINED WITH PREOCCUPATION OF KEY OFFICIALS WITH THE CAMPAIGN, SLOWED THE DECISION-MAKING APPARATUS AND CAUSED SOME DELAYS IN KEY AREAS SUCH AS OIL AND FOREIGN INVESTMENT. ALTHOUGH THERE HAD BEEN SPECULATION THAT THERE MIGHT BE SOME SHIFTS IN KEY CABINET POSITIONS AFTER THE 1977 ELECTIONS, NONE WERE MADE AND NONE ARE EXPECTED UNTIL AFTER THE MARCH 1978 PRESIDENTIAL ELECTIONS. ACCORDINGLY, FOR THE BALANCE OF 1977 IT WAS BUSINESS AS USUAL, MEANING CONTINUATION OF EMPHASIS ON STABILITY,
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REDUCTION IN INFLATION, COMPLETION OF THE SECOND FIVE-YEAR DEVELOPMENT PROGRAM, ATTEMPTS TO REPAIR THE CRACKS IN THE FOREIGN INVESTMENT SITUATION, AND RESOLUTION OF THE PROBLEMS ARISING FROM THE TRADING LAW (WHICHREQUIRES FOREIGN TRADING COMPANIES TO TURN THEIR ACTIVITES OVER TO INDONESIAN ENTITIES). THERE WAS ALSO CONSIDERABLE PREOCCUPATION AT THE SENIOR LEVELES TO RESOLVING MAJOR

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PROBLEMSIN THE OIL SECTOR SUCH AS THE IRS AND LNG MATTERS. THE MOMENTUM OF ASEAN ACTIVITIES WAS SUSTAINED WITH CONSIDERABLE ATTENTION DEVOTED TO THE VARIOUS DIALOGUES, (U.S., ED, AND JAPAN), THE ASEAN SUMMIT AND SUBSEQUENT VISIT OF JAPANESE PRIME MINISTER, AND TO MAJOR INTRA-ASEAN ISSUES SUCH AS THE PREFERENTIAL TRADING AGREEMENT, TARIFF REDUCTIONS, AND ASEAN INDUSTRY PROJECTS. AFTER THE MAY ELECTIONS WE DETECTED SOME EASING IN GOI'S EARLIER TOUGH STANCE ON ASEAN TRADE PREFERENCES.

3. DEVELOPMENTS DURING THE ELECTION CAMPAIGN, PARTI-CULARLY THE GOVERNMENT'S DIALOGUES WITH THE STUDENTS, GENERATED SOMEWHAT GREATER ATTENTION BY GOI TO THE PROBLEMS OF INCOME DISTRIBUTION. AFTER SUHARTO'S DISPUTED STATEMENT IN AUGUST 16 NATIONAL DAY SPEECH THAT THOSE BENEATH POVERLY LINE HAD DRAMATICALLY DECREASED, SUBJECT BECAME FOCUS OF MUCH POLITICAL ATTENTION. THERE WAS AN INCREASE IN PUBLIC STATEMENTS BY KEY OFFICIALS ON THIS SUBJECT, STEPPED UP EFFORTS TO DEFINE THE PROBLEM BY SUMITRO'S MINISTRY OF RESEARCH BUT NO NEW POLICY INITIATIVES. DURING THE SCOND HALF OF THE YEAR SENIOR OFFICIALS WERE MUCH PREOCCUPIED WITH THE FOOD PROBLEM AND RICE IMPORTS.

4. ANTI-CORRUPTION CAMPAIGN: PROBABLY THE MOST SIGNI-FICANT AFTER-ELECTION EVENT WAS THE INITIATION OF A CONFIDENTIAL

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MAJOR ANTI-CORRUPTION CAMPAIGN WHICH RECEIVED MUCH PUBLIC ATTENTION. WE BELIEVE THAT PRINCIPAL MOTIVATIONS UNDER-LYING GOI DECISION WERE PRE-ELECTION CRITICISMS OF CORRUPTION, GOI REALIZATION THAT CORRUPTION HAS SERIOUS NEGATIVE IMPACT ON ATTITUDE OF FOREIGNERS TOWARDS DOING BUSINESS WITH INDONESIA, AND THE GENTLE PRESSURES OF THE INTERNATIONAL DONOR COMMUNITY AT THE APRIL 1977 IGGI MEETING (WHEN "COMMERCIALIZATION OF GOVERNMENT ACTIVITIES" WAS SUBJECT OF DISCUSSION). ALTHOUGH THIS WAS NOT A FOCUS OF THE CAMPAIGN, IT IS CONCEIVABLE THAT THERE HAS ALSO BEEN SOME RECOGNITION AT THE TOP THAT CORRUPTION TENDS TO DISTORT GOI ECONOMIC PLANNING INTO FAVORING LARGE CAPTIAL INTENSIVE PROJECTS WHERE POSSIBILITIES OF PAY-OFFS ARE GREATER, THAT CORRUPTION HAS A DISTORITING IMPACT INSOFAR THAT IT INCREASES THE OPPORTUNITY COSTS OF NEW INVESTMENT AND IMPEDES RATIONAL ALLOCATION OF THE COUNTRY'S SCARCE ECONOMIC RESOURCES.

5. BENEATH THE INTIAL CYNICISM ABOUT THE CAMPAIGN THERE WAS ALSO A GREAT DEAL OF HOPE, ESPECIALLY IN THE FOREIGN BUSINESS COMMUNITY.ALTHOUGH SUPPORT FOR THE CAMPAIGN HAS NOT DISAPPEARED, IT HAS NOW GONE ON LONG

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ENOUGH THAT THE OTHER SIDE IS BEING HEARD FROM.
INCREASED COSTS, ESPECIALLY BECAUSE OF LONGER SHIP TURN-
AROUND TIMES, TIE-UP IN CUSTOMS OF NEEDED EQUIPMENT AND
SPARE PARTS, AND DELAYS IN ISSUING WORK PERMITS AND
VISAS, HAVE CREATED SUFFICIENT "REVERSE" ECONOMIC
PROBLEMS PROMPTING MANY BUSINESSMEN TO HAVE A RENEWED
APPRECIATION FOR THE NEED FOR "SPEED MONEY". SOME
JANANESE BUSINESSMEN HAVE COMPLAINED THAT ANTI-CORRUPTION
CAMPAIGN DESTABLIZES PREDICTABILITY OF BUSINESS PRACTICES.

6. AS OF THE MOMENT INDICATIONS ARE THAT GOI IS DETERMINED
T CONTINUE CAMPAIGN EVEN IF, AS ADMIRAL SUDOMO TOLD
AMBASSADOR, IT WILL TAKE MANY YEARSTO ACCOMPLISH ITS
OBJECTIVES. DURING THE FEW MONTHS PRIOR TO THE PRESI-
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ENTIAL ELECTIONS THE CAMPAIGN MAY TAKE ON A SOMEWHAT
LESS SPECTACULAR CHARACTER IN ORDER TO AVOID PUBLIC
EMBARRASSMENT OF TOP LEADERS IN GOVERNMENT WHOSE POLITICAL
AMBITIONS WOULD NOT TOLERATE SUCH EMBARRASSMENT.

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BEYOND THE ELECTIONS, AND ASSUMING SUHARTO'S RE-ELECTION,
THE CAMPAIGN LIKELY WILL BE CONTINUED RESULTING IN FURTHER
"SLOW-DOWNS" AND UNCERTAINTIES IN SOME OF THE SERVICE
SECTORS BUT HOPEFULLY ALSO STRENGTHENING THE COUNTRY'S
OVERALL REPUTATION FOR FOREIGN INVESTMENT AND TRADE.

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7. AFTER THE ELECTIONS THERE WILL BE SOME CHANGES IN
KEY CABINET POSITIONS BUT AT THIS POINT WE DOUBT THAT
THE BASIC THRUST OF INDONESIA'S ECONOMIC POLICIES AND

THEIR ATTITUDES IN INTERNATIONAL ECONOMIC FORA WILL
CHANGE TO ANY MARKED DEGREE. EMPHASIS WILL CONTINUE
TO BE ON COMPLETION OF THE SECOND FIVE-YEAR DEVELOPMENT
PROGRAM AND PREPARATION OF THE THIRD FIVE-YEAR PROGRAM
THAT WILL PROBABLY EMPHASIZE FOOD PRODUCTION, TRANSMIGRATION
AND EMPLOYMENT CREATION. PERHAPS THE KEY TO IMMEDIATE
FUTURE WAS SUHARTO'S 1978 BUDGET SPEECH STATEMENT THAT
GOI SHOULD CONTINUE TO SEEK A TRADE-OFF BETWEEN ECONOMIC
DEVELOPMENT AND STABILITY. HE SAID THAT "STABILITY THAT
IS CAPABLE OF STIMULATING DEVELOPMENT AND DEVELOPMENT THAT
DOES NOT JEOPARDIZE STABILITY CONSTITUTE THE MAIN POLICY".

B. 1977 ECONOMIC HIGHLIGHTS AND THEIR POLICY IMPLICATIONS

8. ON BALANCE, 1977 WAS A GOOD YEAR FOR THE INDONESIAN
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ECONOMY. INCREASED OIL PRODUCTION COMBINED WITH CON-
TINUING HIGH PRICES FOR NON-OIL EXPORTS YIELDED RECORD
EXPORT EARNINGS AND, TOGETHER WITH LARGE CAPITAL INFLOWS
(MOSTLY ODA), RESULTED IN ANOTHER SUBSTANTIAL BALANCE OF
PAYMENTS SURPLUS. THE CONSEQUENT BUILD-UP OF A COMFORTABLE
FOREIGN RESERVE CUSHION GAVE THE GOI THE CONFIDENCE IN LATE
1977 TO RE-ENTER THE CAPITAL MARKET, PREPAYING $200 MILLION
ON THE $1 BILLION BOP SYNDICATIONS OF 1975 AND NEGOTIATING
CONSIDERABLY MORE FAVORABLE TERMS ON THE $575 MILLION
WHICH REMAINS TO BE PAID. THIS DEBT RESTRUCTURING REDUCES
THE GOI'S DEBT SERVICE RATION IN THE SHORT TERM TO WELL
BELOW THE PREVIOUSLY PROJECTS 20 PERCENT WARNING LEVEL
AND WILL GIVE THE GOI FLEXIBILITY IN FINANCING CERTAIN
KEY DEVELOPMENT PROJECTS. ALSO IN 1977, INDONESIA
COMMENCED LNG SHIPMENTS FROM THE FIRST OF TWO ENORMOUS
LNG INVESTMENT PROJECTS, IT BECAME A NET EXPORTER OF
UREA FERTILIZER AND IT MOVED CLOSER TO BECOMING SELF-
SUFFICIENT IN CEMENT. EACH OF THESE DEVELOPMENTS HAS
IMPORTANT LONGER TERM FOREIGN EXCHANGE IMPLICATIONS.
OVERALL GROWTH IN THE ECONOMY WAS PROBABLY ON THE ORDER
OF 7 PERCENT. INFLATION WAS FURTHER REDUCED TO ABOUT
A 12 PERCENT RATE.

9. NOTHWITHSTANDING THIS STRONG, EXPORT-LED RATE OF
GROWTH, HOWEVER, THE ECONOMY WAS NOT WITHOUT PROBLEMS
IN 1977. DOMESTIC BUSINESS ACTIVITY REMAINED SLUGGISH
THROUGHOUT THE YEAR, JOB OPPORTUNITIES FOR AN EXPANDING
LABOR FORCE REMAINED SCARCE, AND INVESTMENT, BOTH
FOREIGN AND DOMESTIC, SHOWED ONLY SLIGHT RECOVERY

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FROM 1976 LOWS. ALTHOUGH THE GOI STREAMLINED INVESTMENT
PROCEDURES AND, AT YEAR'S END, EXPANDED CREDIT TO SPUR
DOMESTIC ACTIVITY, THESE CHANGES ARE UNLIKELY TO REVIVE
BUSINESS INTEREST TO THE LEVELS OF THE FIRST HALF OF
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THE 1970'S OR RELIEVE EMPLOYMENT PRESSURES. ALSO IN
1977, RICE PRODUCTION FELL, NECESSITATING RECORD IMPORTS.
ALTHOUGH WEATHER AND INSECT PROBLEMS CONTRIBUTED TO THE
SHORTFALL, THE PRODUCTION DECLINE HIGHLIGHTED SERIOUS
PROBLEMS IN FOOD POLICY, WHICH WILL CONSTITUTE A SIGNI-
FICANT FOREIGN EXCHANGE DRAIN IN THE FUTURE. FINALLY,
AND PERHAPS MOST IMPORTANT OF ALL, BY YEAR'S END
IT WAS BECOMING APPARENT THAT INCREASED DOMESTIC DEMAND
AND LEVELING OFF OF PETROLEUM PRODUCTION MAY CAUSE A
DROP IN OIL EXPORTS IN 1978 WITH CONSIDERABLE UNCERTAINTY
AS TO WHEN, IF EVER, OIL EXPORTS MIGHT RETURN TO 1977'S
RECORD LEVEL.

10. THESE DEVELOPMENTS WILL MEAN THAT WHILE THE GOI
NOW HAS SOME BREATHING SPACE IN TERMS OF FOREIGN EXCHANGE
RESERVES AND DEBT SERVICING, IT WILL NEVERTHELESS HAVE
TO CONTINUE TO FOLLOW A POLICY OF RESTRAINT IN ITS
BORROWING AND ITS DEVELOPMENT UNDERTAKINGS. (THE
FY 78/9 BUDGET, IN REAL TERMS LESS THAN 2 PERCENT ABOVE
THE PREVIOUS YEAR'S, WOULD APPEAR TO SIGNAL GOI ACCEPTANCE
OF THE NEED FOR TIGHT CONTROLS.) WTIH THE GOI'S OIL
REVENUES NO LONGER BUOYANT, THE GOVERMENT ALSO WILL
HAVE TO ACCELERATE ITS EFFORTS TO IMPROVE DOMESTIC
RESOURCE MOBILIZATION. NON-OIL EXPORTS WILL HAVE TO BE
EXPANDED AND DIVERSIFIED MORE QUICKLY THAN ORIGINALLY
PLANNED. INVESTMENT WILL NEED FURTHER ENCOURAGEMENT,
ESPECIALLY IN OIL EXPLORATION ACTIVITIES. EXCHANGE
RATE POLICY AND IT EFFECT ON INVESTMENT, EMPLOYMENT
AND EXPORTS WILL NEED TO BE RE-EXAMINED. CONTINUED
LARGE INFLOWS OF CONCESSIONAL ASSISTANCE WILL BE NEEDED
IF DEVELOPMENT PROGRAMS ARE TO MAINTAIN THE CURRENT
MOMENTUM.

1. POLICY IMPLICATIONS: THESE AFOREMENTIONED PRIORITIES
OF THE GOI HAVE IMPORTANT BILATERAL POLICY IMPLICATIONS
FOR THE USG. FIRST, IT WILL BE IMPORTANT THAT WE MAIN-
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TAIN AND PERHAPS EXPAND OUR ECONOMIC ASSISTANCE TO
INDONESIA AS ITS DEVELOPMENT NEEDS INCREASE. THE GENERAL

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THRUST OF OUR ASSISTANCE PROGRAMS, IN THE AREAS OF TRAINING, AGRICULTURAL AND RURAL DEVELOPMENT AND POPULATION PLANNING, APPEAR WELL-DIRECTED, THOUGH WE SHOULD REMAIN SENSITIVE TO THE NEED FOR FLEXIBILITY IN OUR PROJECT SELECTION AND DESIGN.

12. WE NEED ALSO TO BE AWARE OF A TREND TOWARDS "BUNCHING UP" OF ASSISTANCE PROGRAMS IN THE AGRICULTURE SECTOR AS MORE AND MORE DONORS SEEM TO BE SHIFTING AWAY FROM INFRASTRUCTURE AND INTO AGRICULTURE WITH THE ATTENDANT DANGER OF OVERLOADING ONE SECTOR AND NEGLECTING

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IMPORTANT REQUIREMENTS IN OTHERS. ALTHOUGH OUR BILATERAL ASSISTANCE AFFORDS US ONLY LIMITED LEVERAGE IN SHAPING GOI PROGRAMS, WE SHOULD ATTEMPT TO USE THAT LEVERAGE TO GOOD ADVANTAGE. WE ALSO SHOULD ACTIVELY PROMOTE GREATER COORDINATION OF OUR BILATERAL AID PROGRAM WITH PROGRAMS OF THE IFI'S AND OTHER BILATERAL DONORS AND, THROUGH THE IGGI MECHANISM, ENCOURAGE THE GOI TO ADDRESS SENSITIVE ISSUES LIKE EXCHANGE RATE POLICY, CORRUPTION AND THE NEED FOR IMPROVEMENT OF ITS ADMINISTRATIVE APPARATUS THROUGH SPECIALIZED TRAINING, ETC., SO IT WILL HAVE, FOR EXAMPLE, THE BUREAUCRATIC CAPACITY TO IMPROVE TAX COLLECTION, CUSTOMS PROCEDURES,AND OTHER SERIOUS ADMINISTRATIVE SHORTCOMINGS WHICH ARE RETARDING DEVELOPING. WE SHOULD, THROUGH THE IGGI AND ON OUR OWN, ASSIST THE GOI IN DESIGNING PROGRAMS TO HELP THE NEEDY EXPECIALLY IN THE AREA OF JOB CREATION. WE MUST ALSO ENCOURAGE INDONESIA IN ITS EFFORTS TO IMPROVE ITS INVESTMENT CLIMATE. LAST BUT NOT LEAST THERE IS A

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VAST AREA OF NEED FOR MANAGEMENT TRAINING AT ALL LEVELS
OF THE INDONESIAN ECONOMY.

13. EXTERNAL DEVELOPMENTS: RELATIVELY SATISFACTORY
CONCLUSION OF CIEC WAS A MILESTONE, PARTICULARLY SINCE
G-8 AGREED TO MOVE FORWARD WITH DISCUSSIONS FOR A COMMON
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FUND. ACCORDINGLY, INDONESIAN ATTITUDES TOWARDS OUR
ROLE IN NORTH-SOUTH RELATIONS MELLOWED, BUT CLOUDY
FUTURE ON CIEC FOLLOW-UP AND UNCERTAINTY ABOUT OUR
STANCE VIS-A-VIS COMMON FUND HAS REVIVED INDONESIAN CON-
CERNS THAT U.S. WILL BE MAIN STUMBLING BLOCK IN DEVELOP-
ENT OF A "NEW ECONOMIC ORDER".

14. INDONESIANS ARE CURRENTLY GROPING WITH QUESTION OF
REVIVIGN COMMON FUND TALKS BUT FIND IT DIFFICULT TO
RECONCILE THEIR OWN DESIRE FOR COMPROMISE SOLUTION WITH
HARD LINE TAKEN BY OTHER LDCS. WHILE WE SUSPECT THAT
GOI WILL TAKE MODERATE POSITION ON "SECOND WINDOW" ISSUE,
WE CANNOT EXPECT THEM TO MODERATE STRONG FEELINGS IN
SUPPORT OF G-77 POSITION FOR OUTSIDE COMMON FUND
FINANCING. THEY SIMPLY DO NOT ACCEPT U.S. VIEW THAT
FUNDS SHOUD COME ONLY FROM EXISTING COMMODITY AGREEMENTS.
CLEARLY AN EFFORT TO WORK OUT A COMPROMISE, PERHAPS
COMBINING COMMODITY AGREEMENT FINANCIAL RESOURCES WITH
SOME FUNDING FROM PARTICIPATING GOVERNMENTS, WILL BE
NECESSARY IF WE ARE TO AVOID A RETURN TO THE CONFRONTATION
OF THE POST-NAIROBI PERIOD.

15. IN THE OPEC REALM INDONESIA STARTED 1977 IN A CON-
CILIATORY MOOD OPTING FOR A PRICE FREEZE AND ELIMINATION
OF TWO-TIER SYSTEM IN ORDER TO MAINTAIN OPEC SOLIDARITY.
WITH THIS OBJECTIVE ACHIEVED, AND UNDER DOMESTIC PRESSURE
TO INCREASE OIL REVENUE, GOI MOVED INTO THE CAMP OF
THOSE OPEC MEMBERS WHO PUSHED FOR A MODERATE PRICE
INCREASE AT MOST RECENT MINISTERIAL MEETING. ALTHOUGH
INDONESIANS CAREFULLY CONSIDER MARKET FACTORS, AND WILL
CONTINUE TO DO SO IN ORDER TO AVOID A DROP IN SALES,
THEIR OFFICIAL STANCE LIEKLY WILL BE TO OPT FOR A
MODERATE PRICE INCREASE AT NEXT SUMMER'S MINISTERAIL
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MEETING. TO SOME EXTENT GOI POSITION WILL BE INFLUENCED
BY SHORT-TERM FACTORS SUCH AS PERCEPTIONS OF POSSIBLE
LOSSES IN REVENUE AS A RESULT OF IRS DECISION, REVIVAL

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OF EXPLORATION ACTIVITIES, PROSPECTS OF FINDING NEW
FIELDS, AND FUTURE FOR LNG SALES (INCLUDING U.S.
ACTIONS ON THE CALIFORNIA CONTRACT).
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